ORIGINAL

Supreme Court, U.S.
FILED
JUN 1 1992
OFFICE OF THE CLERK

No. 91-7804

IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1991

SHELDON B. BUFFERD, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

KENNETH W. STARR
Solicitor General

JAMES A. BRUTON
Acting Assistant Attorney General

ROBERT S. POMERANCE
JANET KAY JONES
Attorneys

Department of Justice
Washington, D.C. 20530
(202) 514-2217

QUESTION PRESENTED

Whether, when a loss and an investment tax credit are erroneously claimed on the return of a subchapter S corporation, and those items "pass through" to the return of a shareholder (with whom an extension of the period of limitation has been duly executed), they may be disallowed on the shareholder's return _after_ the limitations period for assessing a tax against the corporation has expired.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases:

Statutes:

PUBLISHER'S NOTE

THE FOLLOWING PAGE IS UNAVAILABLE FOR FILMING

PG.III

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-5a) is reported at 952 F.2d 675.* The opinion of the Tax Court (Pet. App. 6a-11a) is reported unofficially at 61 T.C.M. (CCH) 2410.

JURISDICTION

The judgment of the court of appeals was entered on January 3, 1992. The petition for a writ of certiorari was filed on March 30, 1992. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1.a. In 1979, petitioner was a shareholder of a qualified small business corporation known as Compo Financial Services,

Inc. Under the provisions of subchapter S of the Internal Revenue Code, all items of income, loss and tax credits of a qualified small business corporation "pass through" to the shareholders of the corporation and are reported on their individual income tax returns. See 26 U.S.C. 1366(a)-(c).1/ The subchapter S corporation is itelf directly liable for tax in only a few, limited circumstances not involved in this case.2/ When items "flow through" to the shareholders, it is the shareholders (rather than the corporation) whose tax is affected by disallowance of erroneous items shown on the corporate return. See ibid.

Under Section 6037 of the Code, Subchapter S corporations are required to file annual income tax returns that serve both

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1/ During the period involved in this case, the subchapter S provisions were located at 26 U.S.C. 1371, et seq. These provisons were modified and renumbered as 26 U.S.C. 1361, et seq. by the Subchapter S Revision Act of 1982, § 2, Pub. L. No. 97-354, 96 Stat. 1669. The modification and reenactment of the subchapter S provisions in 1982 did not affect the issue presented in this case. See pages 13-15, infra.

2/ During the period relevant to this suit, a subchapter S corporation was itself liable for tax only in limited circumstances. It was subject to a special tax imposed on certain of its long-term capital gains under 26 U.S.C. 1378 (1976). Such gains also could generate a "minimum tax" on the corporation under Sections 56 and 58(d)(2) as then in effect. See B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 6.06, at 6-26 to 6-28 (4th ed. 1979). Otherwise, however, so long as the corporation preserved its subchapter S status, it was exempt from the regular income tax imposed on other corporations by Section 11, and its gains, losses, and credits were apportioned to its shareholders according to their respective interests in its stock. In that respect, the "pass through" treatment afforded a subchapter S corporation and its shareholders resembles the treatment historically afforded to a partnership and its partners. See United States v. Basye, 410 U.S. 441, 448 n. 8 (1973).

(i) as "information returns," providing detailed information on income and deductions for the preparation of individual shareholder returns and (ii) as corporate returns in the limited situations when the corporation is itself liable for tax (see note 2, supra). See Fehlhaber v. Commissioner, 954 F.2d 653, 655 (11th Cir. 1992). Pursuant to Section 6037, the subchapter S corporation of which petitioner was a shareholder reported an erroneous loss deduction and tax credit for 1979 that "passed through" to petitioner's individual income tax return for that year (Pet. App. 2a, 8a-9a).

b. Section 6501(a) of the Internal Revenue Code generally requires that any assessment of income taxes be made by the Internal Revenue Service "within 3 years after the return was filed." 26 U.S.C. 6501(a).3/ This three-year limitations period may be extended by a written agreement signed by the IRS and the taxpayer before the period expires. 26 U.S.C. 6501(c)(4). If the Internal Revenue Service mails a notice of deficiency to a taxpayer while the assessment period is still open (by virtue of such an extension or otherwise), and if the

3/ 26 U.S.C. 6501(a) provides:

> Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) or, if the tax is payable by stamp, at any time after such tax became due and before the expiration of 3 years after the date on which any part of such tax was paid, and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period.

taxpayer timely seeks review of the deficiency in the Tax Court, the assessment period stays open until after the Tax Court's decision becomes final. 26 U.S.C. 6503(a)(1).

In March 1983, before the three-year period for assessing petitioner's 1979 taxes expired, petitioner and the Internal Revenue Service signed a consent to extend the period in accordance with Section 6501(c)(4). In December 1987, within the period so extended, the Service mailed petitioner a notice of deficiency. The notice asserted a deficiency in petitioner's income tax for 1979 based upon the disallowance of his distributive share of the erroneous loss deduction and tax credit reported by Compo.4/

Petitioner filed a timely Tax Court petition for review of the deficiency (Pet App. 2a, 9a-10a). While not disputing that the assessment period applicable to his individual tax return remained open due to his extension agreement and petition to the Tax Court (Pet. App. 5a), petitioner claimed that disallowance on his return of the "pass through" items from the subchapter S corporation was time-barred because the period for assessing a tax against that corporation had lapsed.

Petitioner's contention was based upon Section 6037(a) of the Code, which indicates that the statute of limitations for a return filed by a subchapter S corporation is the same as for a

4/ The deficiency also resulted in part from disallowance of a separate loss deduction that petitioner claimed from his investment in a partnership. That adjustment was resolved before the Tax Court issued its opinion in this case (Pet. App. 8a).

return filed by a normal business corporation under Section 6012 of the Code. See 26 U.S.C. 6037(a). The 1979 return of Compo Financial was filed on or before February 15, 1980 (Pet. App. 9a). Because the adjustments to the erroneous deduction and tax credit that "passed through" to petitioner in this case did not create any tax liability for the subchapter S corporation, and since that corporation was not liable for petitioner's tax deficiencies resulting from inclusion of the erroneous subchapter S corporation deductions and tax credits, the Service did not seek an extension of the limitations period for assessing taxes against the corporation for 1979. The three-year period for making an assessment against the corporation for taxes it owed under its 1979 return thus expired on February 15, 1983, before the IRS mailed a notice of deficiency to petitioner.

2. The Tax Court concluded that the period for assessing the deficiency in petitioner's taxes had not expired (Pet. App. 6a-11a). The court held that the period during which taxes may be assessed under Section 6501 "is measured with reference to the individual shareholder's income tax return, rather than the [subchapter S] corporation's information return" (id. at 10a). In so ruling, the court followed its unanimous, reviewed decision in Fehlhaber v. Commissioner, 94 T.C. 863 (1990), aff'd, 954 F.2d 653 (11th Cir. 1992). The Tax Court acknowledged that its decisions in Fehlhaber and in this case were in conflict with Kelley v. Commissioner, 877 F.2d 756 (1989), where the Ninth Circuit held that "pass through" items from a subchapter S

corporation could not be disallowed on the return of an individual shareholder after the time for assessing a tax against the corporation had expired. The Tax Court concluded that Kelley was wrongly decided and declined to apply it in cases not appealable to the Ninth Circuit (Pet. App. 11a).

3. The Second Circuit affirmed (Pet. App. 1a-5a). The court of appeals concluded that, under the "clear and unambiguous" language of the statute, "the relevant return for purposes of section 6501(a) is [petitioner's] return rather than Compo's S corporation return" (Pet. App. 4a, 5a). In the court's view, Sections 6037 and 6051 created no impediment to assessing petitioner for his personal tax deficiency produced by adjustments to his share of "pass through" items derived from the subchapter S corporation's return. The court explained that "[a]n adjustment to the return of an S corporation that does not impose tax liability on that S corporation is not barred by sections 6501(a) and 6037" (id. at 4a). For this reason, the court of appeals expressly "disagree[d]" with the contrary decision of the Ninth Circuit in Kelley (id. at 4a).

DISCUSSION

The court of appeals correctly held that expiration of the period for assessing taxes against a subchapter S corporation does not bar the Internal Revenue Service from disallowing erroneous corporate deductions and credits that "flow through" to the individual shareholders' returns. Petitioner is correct, however, in noting (Pet. 5-9) that this case involves a recurring

question of substantial importance that has produced conflicting decisions among the circuits. We therefore do not oppose the granting of certiorari.

1. Section 6501(a) of the Internal Revenue Code provides that "the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed." 26 U.S.C. 6501(a).5/ Under the plain language of this statute, an assessment is not barred unless it is made more than three years after the filing of "the return" of the taxpayer against whom the tax is assessed. Since the taxes resulting from the income and deductions that "flow through" to the shareholder of a subchapter S corporation are owed by the shareholder, and not by the corporation, the period for assessing the shareholder's taxes runs from the filing of his return. Before that period expired in this case, petitioner agreed to extend it in accordance with Section 6501(c)(4) of the Code (Pet. App. 5a). The notice of deficiency was mailed to petitioner within the period so extended and, therefore, within the time allowed by the statute.

It is irrelevant that the three-year period for assessing taxes that might, in some other situation (see note 2, supra), be owed by the subchapter S corporation had expired before the deficiency notice was issued to petitioner. The subchapter S corporation is not itself liable for taxes on the income and

5/ Because a statute of limitations is invoked to bar the collection of taxes otherwise lawfully due, its terms are to be construed narrowly in favor of the government. See Badaracco v. Commissioner, 464 U.S. 386, 391-392 (1984).

deductions that "pass through" to its shareholders; only the shareholders are liable for taxes on these items. Moreover, the income tax return of the subchapter S corporation obviously does not contain sufficient information to compute the shareholders' tax liabilities, which depend not only on the "pass through" items from the subchapter S corporation but also on income, deductions, and exemptions received from other sources. See Siben v. Commissioner, 930 F.2d 1034, 1036 (2d Cir. 1991), cert. denied, 112 S.Ct. 429 (1991).

The court of appeals correctly rejected petitioner's contention (Pet. 7) that Section 6037 of the Code requires a different conclusion. Under Section 6037, a subchapter S corporation is required to file an information return each year and is to report its tax liability in the limited situations when it is directly liable for tax (Pet. App. 4a; see note 2, supra). In those limited circumstances, the period for assessing a tax directly against the subchapter S corporation runs from the date that its return is filed. Because the erroneous losses and credits claimed by the subchapter S corporation "pass through" to its shareholders, however, it is the shareholders -- not the subchapter S corporation -- who are liable for taxes resulting from disallowance of the erroneous items. It is thus from the date that the shareholders' returns are filed -- not the date that the corporation's return was filed -- that the limitations period for assessment runs under Section 6501(a). See Pet. App. 4a.

2. We agree with petitioner (Pet. 5), however, that Kelley v. Commissioner, 877 F.2d 756 (9th Cir. 1989), squarely conflicts with the decision in this case. In Kelly, the Internal Revenue Service asserted an income tax deficiency against a shareholder of a subchapter S corporation with respect to the disallowance of a deduction that "passed through" to the shareholder from the corporation. The Ninth Circuit held that the time for assessing the individual shareholder's tax liability ran from the filing of the return of the subchapter S corporation and that the notice of deficiency issued to the shareholder in that case was therefore untimely. The reasoning of the court in Kelley was (i) that, under Section 6037, any assessment against a subchapter S corporation for taxes it might owe directly is barred three years after the corporate return is filed and (ii) that, since a subchapter S corporation may discard its books and records following expiration of the three-year period for assessing any taxes against it directly, the shareholders would be left with no way to document "flow-through" items claimed on their personal returns. 877 F.2d at 758-759.6/

6/ The Ninth Circuit followed Kelley in Holmes v. Director of the Dept. of Rev. & Taxation, 937 F.2d 481 (1991), which concerned the analogous question of the timeliness of an assessment against a shareholder in a subchapter S corporation under the revenue laws of Guam, which mirror the Internal Revenue Code. Similarly, in Fendell v. Commissioner, 906 F.2d 362 (8th Cir. 1990), the Eight Circuit held that the income tax liability of a trust beneficiary for items of income that were distributed to the beneficiary from a trust could not be assessed after the limitations period for assessing taxes directly against the trust had expired.

In this case, however, the Tax Court and the Second Circuit specifically "disagree[d]" with the reasoning and result of Kelley (Pet. App. 4a, 10a-11a). The court of appeals correctly concluded in this case that the provisions of Section 6037 -- which concern the limitations period that applies when a subchapter S corporation is directly liable for a tax (see note 2, supra) -- have no bearing on the limitations period under Section 6501(a) for the assessment of tax for items of income that "pass through" to the individual shareholders of the corporation under 26 U.S.C. 1366(a)-(c). The court of appeals also correctly disagreed with the unsupported assumption in Kelley that shareholders lack proper access to corporate records needed to support "pass through" items of subchapter S income reported on their returns (Pet. App. 4).

The recent decision of the Eleventh Circuit in Fehlhaber v. Commissioner, 954 F.2d 653 (1992), also conflicts with the Ninth Circuit's decision in Kelley. In Fehlhaber, the IRS disallowed a shareholder's claim to a distributive loss from a subchapter S corporation and asserted an income tax deficiency against the shareholder on that basis. The deficiency notice was issued to the shareholder less than three years after he filed his personal return but more than three years after the filing of the return of the subchapter S corporation. Id. at 654-655. The Eleventh Circuit held that the assessment in that case was timely; in so holding, the court acknowledged that its decision was "in conflict with the Ninth Circuit's opinion in Kelley" (id. at

657).7/ See also Siben v. Commissioner, 930 F.2d at 1037 (period for assessing taxes owed by a partner based upon adjustments to "pass through" partnership items runs from the date of the partner's personal return, not from the date of the partnership return).

3.a. The conflict created by Kelley, Fehlhaber, and the decision in this case concerns a recurring matter of considerable administrative importance. Subchapter S corporations are often used for distributing deductions and tax credits to investors for application against their income from other sources. When the Internal Revenue Service proposes to audit or make adjustments to an individual shareholder's personal return on account of such "pass through" items, the Service frequently seeks the shareholder's consent to extend the time for assessing his taxes without obtaining extensions from the subchapter S corporation.

Such extensions of the limitations period have a significant and productive role in the process of determining taxes because they facilitate review and compromise of tax disputes before a formal notice of deficiency is issued. Under the decision of the Ninth Circuit in Kelley, however, the Service apparently would be required to proceed directly (even if precipitously) against the shareholder in circumstances where an effective consent to extension cannot be secured.

7/ A similar question as to the timeliness of an income tax deficiency asserted against a shareholder in a subchapter S corporation is pending before the Fifth Circuit in Green v. Commissioner, No. 90-4629.

The Service advises us that a survey of cases currently under audit, involving shareholders of approximately 2,000 subchapter S corporations, has identified approximately $100 million of revenue that may be jeopardized if the period for assessing the shareholders were deemed coterminous with that applicable to the corporations. This same issue would be expected to recur frequently in future audit periods.

b. The prospective impact of the question presented in this case is not materially reduced by Section 4(a) of the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669, which added Sections 6241 through 6245 to the Internal Revenue Code for tax years after 1982. Under these new provisions, the unified audit and litigation procedures applicable to partnerships (see 26 U.S.C. 6221 et seq., as enacted by the Tax Treatment of Partnership Items Act of 1982, Pub. L. No. 97-248, 96 Stat. 324, 648) are extended to subchapter S corporations for tax years beginning in 1983. The objective of these provisons is to provide unified treatment of subchapter S items at the corporate level, rather than examining each shareholder's return separately. See Fehlhaber v. Commissioner, 954 F.2d at 657. The new provisons thus generally specify that the period for assessing a shareholder's tax attributable to a subchapter S "pass through" item begins on the date on which the corporation's return was filed. See 26 U.S.C. 6229(a), 6244 (1982). Congress recognized, however, that this represents a departure from the prior law, under which "[t]he filing by the corporation of its

return does not affect the statute of limitations applicable to the shareholders." S.Rep. No. 97-640, 97th Cong., 2d Sess. 25 (1982).

Notwithstanding the apparently broad scope of these new, unified audit provisions, the question presented in this case remains of substantial, continuing importance. Under regulations authorized by Congress as part of the 1982 legislation (see 26 U.S.C. 6341), the Service has specified that the unified audit procedures of the Act are not applicable to subchapter S corporations that have five or fewer shareholders. See Temp. Reg. § 301.6241-1T(c)(2)(i) (1987).8/ The Service advises us that the vast majority of subchapter S corporations (perhaps as many as 95%) have five or fewer shareholders and therefore fall within the excepted category of the regulations. The question presented in this case, and its recurring administrative

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8/ The temporary regulation is effective for subchapter S corporations whose returns are due on or after January 30, 1987. See Eastern States Casualty Agency, Inc. v. Commissioner, 96 T.C. 773, 781 (1991). The regulation was adopted as a counterpart to the statutory exception from the unified audit procedures for "small" partnerships that have ten or fewer partners (26 U.S.C. 6231(a)(1)).

For the period prior to the effective date of the temporary regulation, the definition of a "small" S corporation under the 1982 Act is unsettled. Compare Arenjay v. Commissioner, 920 F.2d 269 (5th Cir. 1991) (S corporation with ten or fewer shareholders is exempt from the unified audit procedures of the 1982 Act), with Eastern States Casualty Agency, Inc. v. Commissioner, 96 T.C. at 774-783 (between 1982 and the effective date of the temporary regulation, all S corporations, even those with only one shareholder, are subject to the unified audit procedures of the 1982 Act).

importance, thus remain largely unaffected by the new unified audit procedures available under the Code.

In the absence of a decision from this Court, the statute of limitations for the assessment of taxes owed by shareholders for items of "pass through" income and deductions from a subchapter S corporation will vary depending solely upon the circuit in which the issue is presented. Resolution of this recurring issue by this Court is needed to avoid continuing uncertainty and inconsistent application of the revenue laws.

CONCLUSION

Respondent does not oppose the granting of the petition for a writ of certiorari.

Respectfully submitted.

KENNETH W. STARR
Solicitor General

JAMES A. BRUTON
Acting Assistant Attorney General

ROBERT S. POMERANCE
JANET KAY JONES
Attorneys

MAY 1992